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HOUSE COMMITTEE ON FINANCE

TESTIMONY OF THE DEPARTMENT OF TAXATION REGARDING SB 831 SD 2, PROPOSED HD 1 RELATING TO TAXATION

TESTIFIER: FREDERICK D. PABLO, DIRECTOR OF TAXATION (OR
DESIGNEE)
COMMITTEE: FIN
DATE: APRIL 4, 2011
TIME: 3:30PM

POSITION: COMMENTS

This bill has two parts. Part I proposes an addition to Chapter 235, Hawaii Revised Statutes, conforming to Section 45D, Internal Revenue Code, providing for a New Markets Tax Credit. This Part applies to taxable years beginning after December 31, 2010. Part II exempts federally tax exempt companies that supply potable water from the income and general excise taxes.

The Department of Taxation (Department) offers comments below regarding Part I. The Department supports Part II of the proposed HD1, regarding section 501(c)(12) organizations that provide potable water, which has a minimal revenue impact.

I. NEW MARKETS TAX CREDIT, GENERALLY.

The purpose of the New Markets Tax Credit is to encourage investment in qualifying entities that provide business and economic development in targeted low-income communities. The tax credit is provided to the investors in these entities.

In order to claim the New Markets Tax Credit, the development entity must be certified before the credits may be claimed. Once certified, the entities may apply for allocation of the credits.

II. COMMENTS REGARDING THE PROPOSED HAWAII NEW MARKETS TAX CREDIT.

The Department has the following comments regarding a proposed conforming amendment to Section 45D, Internal Revenue Code—

HAWAII CONNECTION—It is unclear from the bill whether the credit only applies to investments that benefit low-income communities in Hawaii. Does the qualified community development entity need to be located in Hawaii or does it apply to any qualified community development entity that services Hawaii? The Department is concerned that the bill as currently drafted does not adequately tie the credit to activity in Hawaii.

IS THIS CREDIT A NEW STATE PROGRAM; OR SIMPLY AN ADDITIONAL CREDIT FOR FEDERAL PROGRAMS?—The Department is unclear whether the State is supposed to be implementing a Hawaii New Markets Tax Credit program or whether this credit is merely an additional credit for federal programs. If a Hawaii program is intended, this measure needs to be amended to provide for the program oversight, as well as the necessary resources. The Hawaii New Markets Tax Credit should likely be managed by an expert state agency on low-income and business development issues.

STUDY OTHER STATES—The Department suggests looking at the approach taken by other states, including Ohio, Illinois, and Louisiana.

REVENUE IMPACT & METHODOLOGY—Part I of the proposed HD1 of this bill will result in an indeterminate revenue impact at this time.

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SUBJECT: INCOME, New markets tax credit

BILL NUMBER: SB 831, Proposed HD 1

INTRODUCED BY: House Committee on Finance

BRIEF SUMMARY: Adds a new section to HRS chapter 235 to provide that Section 45D (with respect to new markets tax credit) of the Internal Revenue Code (IRC) shall be operative for state income tax purposes.

A taxpayer who holds a qualified equity investment on a credit allowance which occurs during the taxable year, may claim a credit equal to the applicable percentage of the amount paid to the qualified community development entity for the investment at its original issue. The applicable percentage shall be the amount in section 45D(a)(2) of the IRC.

Tax credits in excess of a taxpayer's net income tax liability may be used as a credit against the taxpayer's income tax liability in subsequent years until exhausted. All claims for a tax credit under this section shall be filed on or before the end of the twelfth month following the close of the taxable year for which the credit may be claimed. Failure to properly and timely claim the credit shall constitute a waiver of the right to claim the credit. Requires the application for a new markets tax credit to be submitted to the director of taxation on forms prescribed by the director of taxation. The credit may be claimed whether or not the taxpayer claims a federal credit under 45D of the IRC.

The determination of the following shall be made under the designated provisions of the Internal Revenue Code, as amended, as follows: (1) credit allowance date shall be made under section 45D(a)(3); (2) qualified equity investment shall be made under section 45D(b), except that reference to "the Secretary" under section 45D(b)(1), shall be to the director; (3) qualified community development entity shall be made under section 45D©; (4) qualified low-income community investment shall be made under section 45D(d); (5) low-income community shall be made under section 45D(e); provided that the population tract referenced shall refer to tracts in the state; (6) recapture of credit shall be made under section 45D(g); provided that the tax for the taxable year shall be increased under section 45D(g)(1) only with respect to credits that were used to reduce state income tax; and (7) basis reduction shall be made under section 45D(h).

The new markets tax credit shall be operative for HRS chapters 241 and 431. Makes conforming amendments to HRS section 235-2.3.

Amends HRS section 235-2.45(d) to provide that IRC section 704 (with respect to a partner's distributive share) shall be operative for purposes of this chapter; except that section 704(b)(2) shall not apply to allocations of new markets tax credits among partners.

SB 831, Proposed HD 1 - Continued

Amends HRS section 235-2.3 to provide that companies that provide potable water under IRC section 501© (12) shall not be subject to state income taxation.

Amends HRS section 237-23 (a) to provide that companies that provide potable water under IRC section 501© (12) shall not be subject to the general excise tax.

EFFECTIVE DATE: Tax years beginning after December 31, 2010

STAFF COMMENTS: On the federal level the new markets tax credit was adopted as part of the Community Renewal Tax Relief Act of 2000 (P.L. 106-554) to address the lack of capital available to businesses and economic development ventures in low-income communities. The new markets tax credit is provided to individuals or corporations that invest in community development entities working in low-income communities. The credit is equal to 5% of the investment in a qualified community development entity for the first three allowance dates and 6% of the investment for the next four allowance dates with the total amount of credit available equal to 39% of the investment over seven years.

This measure proposes to make the new markets tax credit operable for Hawaii income tax purposes. It should be remembered that Hawaii generally does not adopt any of the credits on the federal level except for the low-income housing tax credit, as Hawaii's income tax rates are not as onerous as those on the federal level.

It should be noted that in recent years investors have shied away from the state low-income housing credits because there are much more generous state income tax credits available to the investor such as the high technology investment tax credit. Adding yet another state credit would merely detract from the low-income housing tax credit. Undoubtedly, affordable housing is one of the priorities for lawmakers. Thus, adopting the new markets tax credit merely dilutes the attractiveness of the low-income housing tax credit. While the new markets tax credit does help to subsidize commercial and retail facilities in a distressed community, given the unbridled use of tax credits to encourage certain business activities, it is questionable whether or not Hawaii's treasury can afford another hit at this time. When and until the legislature decides what is state government's priority, be it affordable housing, high technology development, alternate energy development, or agriculture, the uncontrolled issuance of back door subsidies is beyond the state's financial capacity.

What this proposal does represent is a lack of legislative understanding of what attracts capital investment to a low-income community and what it takes to retain that enterprise in the community. In some ways this proposal is the compliment of what the federal government did with its welfare programs of the 60's, designing model programs based on a particular city or town on the mainland and trying to replicate it throughout the nation. The cookie cutter approach, as many have learned, does not work. Buying into a federal income tax credit program designed to attract capital to a low-income community does not recognize the many unique hurdles that challenge such a venture in Hawaii.

While the proposal picks up the federal definition of low-income community from the New Markets Tax Credit which defines that community as having a poverty rate of at least 20% or a census tract where the median family income does not exceed 80% of the statewide median family income, that definition would probably apply to every census tract in Hawaii save for some in the more affluent communities. Because of the cost of living is so high in Hawaii many families are not only two wage earner families, but in many cases both spouses work two or more jobs. As a result, the statewide

median family income is much higher than what would be found on the mainland. In Hawaii the family of four meeting this criteria of 80% of statewide median family income would qualify if they earned \$79,450, for a two-member family the qualifying income would be \$63,600. These families would hardly be considered in poverty.

Finally, it should be remembered that if this measure is adopted, moneys for the proposed tax credit will, no doubt, come out of the state's general fund and depending on the tax credit, will reduce the amount of available general funds without legislative intervention. These are funds that could be used to fund essential services or in the alternative reduce the tax burden on low and moderate-income families or the overall tax burden that plagues both families and businesses.

If it is the desire of the legislature to provide funding to revitalize economically depressed areas of the state, a direct appropriation would be preferable than adoption of the proposed measure. Better yet, lawmakers may want to look at ways to improve the overall business climate, from streamlining zoning and permitting to a reduction of the general excise tax on business-to-business transactions that will benefit all businesses in Hawaii.

Under current law, IRC 501© (12) organizations, while exempt from federal income taxation, are taxable under the state income tax provisions.

While this measure would exempt from state income and general excise taxation an IRC 501(c)(12) organization that provides potable water, it would provide preferential tax treatment to a very select group of taxpayers. From the standpoint of equity, such preferential treatment should be granted to all IRC 501(c)(12) organizations with a sunset date of one year to allow the legislature to determine the effects and outcomes of the exemption and whether it should be continued or repealed. At the very least, the department of taxation should be tasked with explaining whether or not such organizations should or should not be recognized as being exempt for state tax purposes.

Like paragraph (12), the other two inoperative paragraphs of section 501© appear to be cooperative types of organizations and perhaps this is the original thinking behind making these sections inoperative. In any case, it would appear to be prudent to examine the underlying reasons for making these particular paragraphs inoperative as well as the implications making this paragraph (12) operative and then only for companies providing potable water.

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**THE HOUSE OF REPRESENTATIVES
 THE TWENTY-SIXTH LEGISLATURE
 Regular Session of 2011**

COMMITTEE ON FINANCE

Chair Fukunaga, Vice Chair Wakai, Members of the Committee:

**Hearing date: Monday, April 4, 2011
 Testimony on SB 831
 (Relating to Taxation)
 New Markets Tax Credits**

Chair Oshiro, Vice Chair Lee, Members of the Committee:

We urge your support of this measure, which provides for conformity to the federal new markets tax credit, based on a certain percentage of an amount paid to a qualified community development entity for a qualified equity investment.

The new markets tax credit ("NMTC") program uses federal income tax credits to attract private-sector capital investment to low-income areas in the United States to help finance community development projects, stimulate economic growth, and create jobs.

Section 45D of the Internal Revenue Code of 1986 allows the tax credit to be claimed for a taxpayer's investment in a qualified development entity. These entities, in turn, invest or lend the capital they raise to qualified businesses located in low-income communities. These entities must be attentive to the low-income community which they serve, such as having residents of low-income communities serve on their boards. The program is administered by the United States Treasury Department and the credits are allocated on a competitive basis.

The tax credit is equal to 39% of the qualified equity investment, is claimed over seven years, and is nonrefundable. Corporations, non-profit organizations, and others can create community development entities and apply for the NMTCs. The credit was originally passed by Congress in 2000 as part of the Community Renewal Tax Relief Act to stimulate investment in low income communities.

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Committee On Finance
April 4, 2011
Page 2

NMTC proceeds have financed activities in distressed urban and rural communities, such as alternative energy companies, charter schools, health care facilities, child care providers, supermarkets, manufacturers, processors, distributors and business incubators. Certain business activities do not qualify as NMTC qualified activities, e.g., small farms, residential rental, gambling, country clubs, suntan facility, massage parlors, golf courses. There is a recapture of the credits if substantially all of the investments are not used for qualified activities.

Every dollar of NMTC investment can be leveraged into multiple expenditures through bank loans in conjunction with equity investments. With the budget deficit and loss of federal earmarks, the NMTC program will help to infuse outside capital into Hawaii, generate jobs and income, which generate tax dollars. The addition of Hawaii tax credits will provide further incentives to locate NMTC investments in Hawaii.

Very truly yours,

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**HOUSE OF REPRESENTATIVES
THE TWENTY-SIXTH LEGISLATURE
REGULAR SESSION OF 2011**

COMMITTEE ON FINANCE

**Hearing Date: April 4, 2011
Testimony on S.B. 831, SD2, HD1 (Proposed)
(Relating to Taxation)**

Chair Oshiro, Vice-Chair Lee, and members of the Committee, thank you for the opportunity to offer comments on **Senate Bill 831, SD2, HD1 (Proposed)**.

My name is Peter Fritz. I am an attorney specializing in tax matters. I offer the following comments.

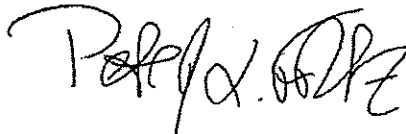
This bill would create a state credit that mirrors the federal New Markets Tax Credit. This bill would help stimulate economic development in economically distressed areas. A state credit would make Hawaii more attractive to Community Development Entities.

New Markets Tax Credits are meant to provide a subsidy to marginal projects -- those that in the absence of the subsidy provided by the credits generate some economic returns but not a sufficient level of returns to make the project economically feasible, and further, those projects which will be rendered economically feasible by the addition of the tax credits. The credit is supposed to make marginally doable projects into doable projects.

I do not have any comments regarding provisions other than those that relate to the New Markets Tax Credit.

Thank you for the opportunity to testify.

Very truly yours,



Peter L. Fritz



April 4, 2011

Representative Marcus Oshiro
Chair, FIN
Representative Marilyn Lee
Vice Chair, FIN
Hawaii State Capitol, Room 308
Honolulu, Hawaii 96813

Aloha Chair Oshiro, Vice Chair Lee, and Members,

I am writing to express my support for Senate Bill 831 SD2. Enterprise Honolulu considers our responsibility in the Hawaii community as the Oahu Economic Development Board crucial to revitalizing our economic condition.

In so doing we are considering all opportunities to bring greater monies into Hawaii and deployed in a responsible manner. This last May Enterprise Honolulu and American Savings Bank established a new entity Punawai O Pu'uhonua as a Community Development Entity so that we could apply to the CDFI for an allocation of \$125 million of Federal New Market Tax Credits for Hawaii. Although Punawai O Pu'uhonua did not receive an allocation this year, our scoring was very high and we have been encouraged to apply again this coming year. We are currently working to securing NMTC funding for some Hawaii projects from mainland companies that did receive allocations this year and this should help make the case to the Department of Treasury that Hawaii has the need and will do good things with an allocation.

As President and CEO for Enterprise Honolulu and a life long resident of Hawaii who's family ties run deep in public service I believe that we all share the burden that our economy finds us. The low income and rural communities of Hawaii too often find that it is the most difficult areas to receive economic funding to stimulate job development. SB 831 SD2 is a state sponsored legislative piece that will work to attract private capital to match the federal legislation. This is key to inspire revitalization investment.

I ask for your consideration to support SB831 SD2 as we do our part to work in concert.

Please feel free to contact me directly should you have any questions.

Sincerely,

Pono Shim
President & CEO
Enterprise Honolulu, Oahu Economic Development Board



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FINTestimony

From: mailinglist@capitol.hawaii.gov
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Subject: Testimony for SB831 on 4/4/2011 3:30:00 PM

Testimony for FIN 4/4/2011 3:30:00 PM SB831

Conference room: 308
Testifier position: oppose
Testifier will be present: No
Submitted by: gregory swartz
Organization: Individual
Address:
Phone:
E-mail: swartzg001@hawaii.rr.com
Submitted on: 4/2/2011

Comments:

As I understand this bill, it will create a new tax credit program allowing primarily wealthy individuals to reduce their tax liabilities. While the tax credit may serve socially desirable goals, I do not believe it is appropriate to create new tax credits in the State's current economy situation, particularly when this Committee is proposing additional individual income taxes through its push for taxation of pensions, limiting the deductibility of State of Hawaii income or excise taxes, and capping itemized deductions overall. Don't take money from one group of taxpayers and give it to another group of taxpayers.